


**EXECUTIVE SECRETARIAT  
ROUTING SLIP**

| TO:      |           | ACTION | INFO | DATE | INITIAL |
|----------|-----------|--------|------|------|---------|
| 1        | DCI       |        |      |      |         |
| 2        | DDCI      |        |      |      |         |
| 3        | EXDIR     |        |      |      |         |
| 4        | D/ICS     |        |      |      |         |
| 5        | DDI       |        |      |      |         |
| 6        | DDA       |        |      |      |         |
| 7        | DDO       |        |      |      |         |
| 8        | DDS&T     |        |      |      |         |
| 9        | Chm/NIC   |        |      |      |         |
| 10       | GC        |        |      |      |         |
| 11       | IG        |        |      |      |         |
| 12       | Compt     |        |      |      |         |
| 13       | D/Pers    |        |      |      |         |
| 14       | D/OLL     |        |      |      |         |
| 15       | D/PAO     |        |      |      |         |
| 16       | SA/IA     |        |      |      |         |
| 17       | AO/DCI    |        |      |      |         |
| 18       | C/IPD/OIS |        |      |      |         |
| 19       | NIO/ECON  | X      |      |      |         |
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|         |
|---------|
| Remarks |
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 Executive Secretary  
 29 Oct 84  
 Date

**3637** (10-81)

## CABINET AFFAIRS STAFFING MEMORANDUM 84 - 9641

Date: 10/26/84 Number: 169088CA Due By:

Subject: Cabinet Council on Economic Affairs Planning Meeting - Tuesday,  
October 30, 1984 - 8:45 a.m. - Roosevelt Room TOPIC: Financial Market Developments

| ALL CABINET MEMBERS | Action                              | FYI                                 |                          | Action                              | FYI                                 |
|---------------------|-------------------------------------|-------------------------------------|--------------------------|-------------------------------------|-------------------------------------|
| Vice President      | <input checked="" type="checkbox"/> | <input type="checkbox"/>            | CEA                      | <input checked="" type="checkbox"/> | <input type="checkbox"/>            |
| State               | <input checked="" type="checkbox"/> | <input type="checkbox"/>            | CEQ                      | <input type="checkbox"/>            | <input type="checkbox"/>            |
| Treasury            | <input checked="" type="checkbox"/> | <input type="checkbox"/>            | OSTP                     | <input type="checkbox"/>            | <input type="checkbox"/>            |
| Defense             | <input checked="" type="checkbox"/> | <input type="checkbox"/>            |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
| Attorney General    | <input type="checkbox"/>            | <input checked="" type="checkbox"/> |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
| Interior            | <input type="checkbox"/>            | <input checked="" type="checkbox"/> |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
| Agriculture         | <input checked="" type="checkbox"/> | <input type="checkbox"/>            | Baker                    | <input checked="" type="checkbox"/> | <input type="checkbox"/>            |
| Commerce            | <input checked="" type="checkbox"/> | <input type="checkbox"/>            | Deaver                   | <input type="checkbox"/>            | <input checked="" type="checkbox"/> |
| Labor               | <input checked="" type="checkbox"/> | <input type="checkbox"/>            | Darman (For WH Staffing) | <input checked="" type="checkbox"/> | <input type="checkbox"/>            |
| HHS                 | <input type="checkbox"/>            | <input checked="" type="checkbox"/> | McFarlane                | <input type="checkbox"/>            | <input checked="" type="checkbox"/> |
| HUD                 | <input checked="" type="checkbox"/> | <input type="checkbox"/>            | Svahn                    | <input checked="" type="checkbox"/> | <input checked="" type="checkbox"/> |
| Transportation      | <input checked="" type="checkbox"/> | <input type="checkbox"/>            | Chapman                  | <input type="checkbox"/>            | <input checked="" type="checkbox"/> |
| Energy              | <input type="checkbox"/>            | <input checked="" type="checkbox"/> |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
| Education           | <input type="checkbox"/>            | <input checked="" type="checkbox"/> |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
| Counsellor          | <input checked="" type="checkbox"/> | <input type="checkbox"/>            |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
| OMB                 | <input checked="" type="checkbox"/> | <input checked="" type="checkbox"/> |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
| CA                  | <input type="checkbox"/>            | <input checked="" type="checkbox"/> |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
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| USTR                | <input checked="" type="checkbox"/> | <input type="checkbox"/>            |                          | <input type="checkbox"/>            | <input type="checkbox"/>            |
| GSA                 | <input type="checkbox"/>            | <input type="checkbox"/>            | Executive Secretary for: |                                     |                                     |
| EPA                 | <input type="checkbox"/>            | <input type="checkbox"/>            | CCCT                     | <input checked="" type="checkbox"/> | <input type="checkbox"/>            |
| NASA                | <input type="checkbox"/>            | <input type="checkbox"/>            | CCEA                     | <input type="checkbox"/>            | <input type="checkbox"/>            |
| OPM                 | <input type="checkbox"/>            | <input type="checkbox"/>            | CCFA                     | <input type="checkbox"/>            | <input type="checkbox"/>            |
| VA                  | <input type="checkbox"/>            | <input type="checkbox"/>            | CCHR                     | <input type="checkbox"/>            | <input type="checkbox"/>            |
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|                     |                                     |                                     | CCNRE                    | <input type="checkbox"/>            | <input type="checkbox"/>            |

## REMARKS:

There will be a Cabinet Council on Economic Affairs Planning Meeting on Tuesday, October 30, 1984, at 8:45 a.m. in the Roosevelt Room.

The agenda and background paper are attached.

## RETURN TO:

☐ Craig L. Fuller  
Assistant to the President  
for Cabinet Affairs  
456-2823 (White House)

☐ Don Clarey ☒ Tom Gibson ☐ Larry Herbolsheimer  
Associate Director  
Office of Cabinet Affairs  
456-2800 (Room 129, OE0B)

DCI  
EXEC  
REG

L300B

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

October 30, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Financial Market Developments (CM # 111)

THE WHITE HOUSE

WASHINGTON

October 26, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*

SUBJECT: Agenda and Papers for the October 30 Meeting

The agenda and papers for the October 30 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider financial market developments and monetary policy. The Working Group on Financial Market Developments has prepared three papers for the Council's consideration.

The first, from Gregory Ballentine, concerns international capital flows. The paper discusses the magnitude of foreign investments in the U.S. and the issue of whether foreigners are helping to finance the budget deficit. A copy of his paper is attached.

The second, from William Poole, concerns the real rate of interest. The paper discusses what has happened to the real rate of interest in recent years and the determinants of the high real rate of interest that we have experienced since 1981. This paper will be circulated to Council members on Monday morning.

The third, from Beryl Sprinkel, concerns the economy, interest rates, and monetary policy. The paper discusses what has happened to interest rates in recent weeks and the principal developments that have led to the improvement in interest rates. It also discusses the outlook for interest rates in the near term and the difficulty of forecasting the timing and intensity of changes in interest rates. A copy of this paper is attached.

Attachments

EXECUTIVE OFFICE OF THE PRESIDENT  
OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

October 26, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: J. Gregory Ballentine *JGB*  
SUBJECT: International Capital Flows

Overview

- o The U. S. is experiencing large net capital inflows.
- o By themselves, large net capital inflows lead to:
  - A stronger U.S. investment market than would result without the net inflows.
  - Tighter foreign capital markets than would result without the net inflow.
- o The net inflow arises from both large gross inflows of foreign investment to the United States and a reduction in gross outflows of U.S. capital abroad.
- o Some have concluded that there have not been increased inflows of foreign investment into the United States; that conclusion is based on a misreading of the data.

Net Capital Flows and The Current Account

- o The emergence of very large net capital inflows into the United States tends to result in the value of the dollar being bid up.
- o The rise in the value of the dollar, in turn, leads to a Current Account deficit that supplies the dollars demanded by the net capital inflow.
- o Traditional analysis held that shifts in the Current Account would be the driving factor in determining the value of a nation's currency and the Capital Account would adjust to finance the Current Account surplus or deficit.
- o Recent experience is a dramatic example of net capital flows being the driving factor.

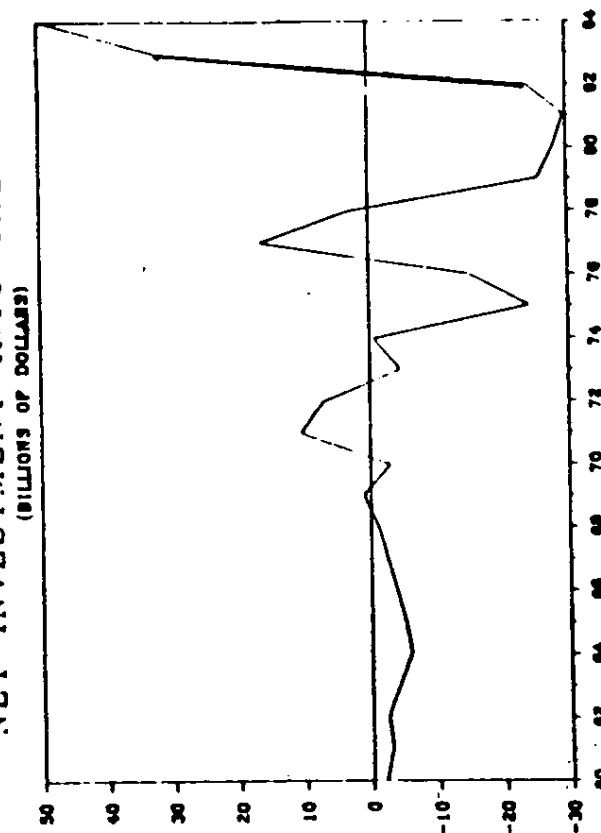


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### The Significance of Net Capital Flows

- o Some observers of foreign economies have claimed that the United States is "draining capital" from those economies. Similarly, some domestic observers have concluded that foreign capital inflows are "helping to finance" our large budget deficit.
- o Both of these effects -- a capital drain and an aid to deficit finance -- arise from a change in net capital flows.
- A foreign capital market experiences the same draining effect when U.S. investors decrease their investment in that market by, say, \$1 billion as when citizens of the foreign country switch from investing \$1 billion in their country to investing \$1 billion abroad.
- We have more saving available to finance domestic investment and the budget deficit when either domestic investors switch \$1 billion from investment abroad to investment in the United States or foreign savers choose to invest \$1 billion more in the United States.
- o Recognizing the significance of net capital flows and the very large change in net capital flows that occurred in recent years (see graph below), it appears that:
  - Our investment market has been able to be stronger than it would have been without the net capital inflow, and
  - Foreign investment markets have been tighter than they would have been without the net inflow to the United States.

### NET INVESTMENT INTO THE U.S.



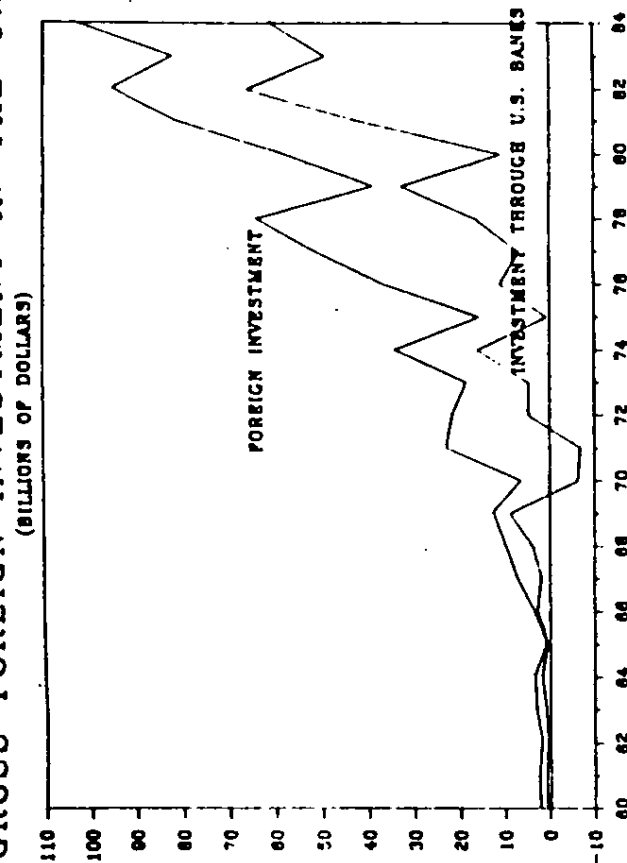
-3-

- o The net investment figure for 1984 in the graph is based on annualizing the investment figures for the first two quarters of 1984. The same is done to get 1984 figures for gross flows shown below.

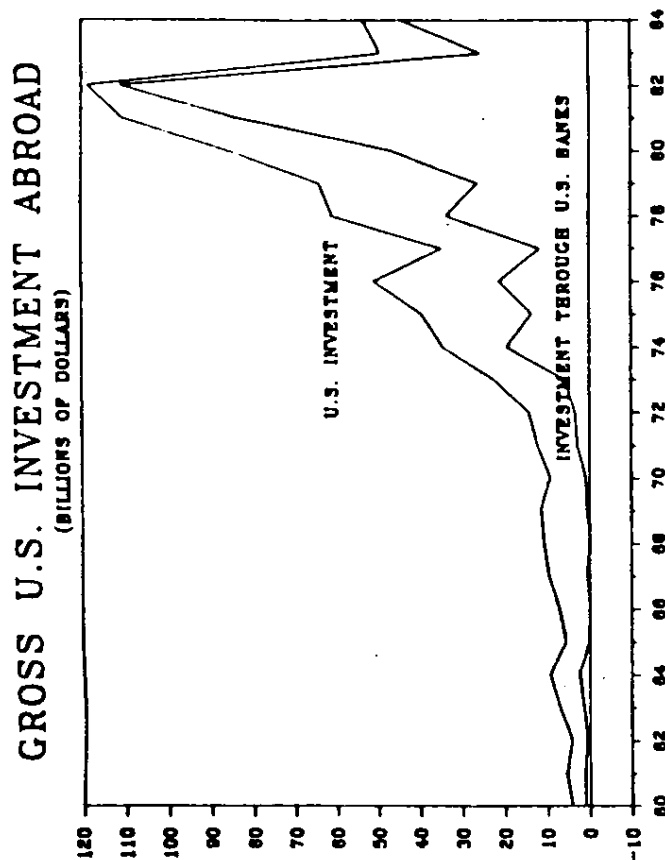
#### Gross Inflows and Outflows of Capital

- o While net international capital flows are the flows relevant for capital markets here and abroad, many have focused on gross inflows or gross outflows in an attempt to conclude whether or not the net flow is due to foreigners investing more in the United States or U.S. investors switching from investing abroad to investing in the United States.
- o In general, the factors that would cause foreigners to decide to invest more in the United States are the same factors that would cause U.S. investors to invest more domestically and less abroad.
- o Thus, one should expect that a net inflow of capital would result from both a rise in gross inflows and a decline in gross outflows.
- o As the graphs below show, this is generally the case; gross inflows of capital in 1981-84 were quite high and gross outflows in 1983 were well below the levels of the late 1970s. Indeed, if one were to say either inflows or outflows were most responsible for the change in net flows, it would appear to be the very large gross inflows of foreign investment that are responsible.

#### GROSS FOREIGN INVESTMENT IN THE U.S.



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- o In spite of the evidence in these graphs, some have argued that the net inflow is not due to more foreign investment in the United States, but to less U.S. investment abroad. This assertion is based on the decline in gross foreign investment in the United States from \$95.2 billion in 1982 to \$81.7 billion in 1983.
- o This decline in foreign investment is misleading.
- Both the 1982 and 1983 gross inflows are very high and the 1984 flows may exceed the flows in both years.
- Part of the 1982 gross inflows arise from bookkeeping type transactions that raised gross inflows and outflows equally, making the 1982 gross investment figures (both inflow and outflow) distorted upward.



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Gross Investment Inflows in 1981 through 1983 and International Banking Facilities

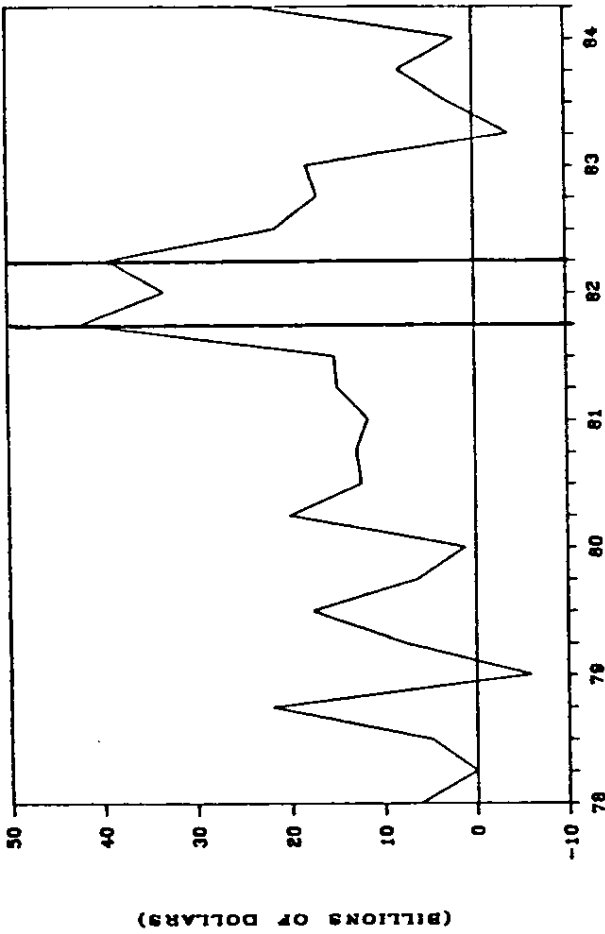
- o The two charts showing gross inflows and outflows of investment also show gross flows through the banking system. The flows through the banking system generally amount to more than half of the total gross flows.
- o In late 1981 International Banking Facilities (IBFs) were introduced in the United States. IBFs are accounts established in U.S. domiciled banking offices that are restricted to loans and deposits for foreign residents and are not subject to ordinary domestic reserve requirements.
- o When IBFs were introduced, many U.S. banks that had held foreigners' deposits off-shore moved those deposits on-shore. Moving such deposits on-shore while leaving the assets (claims) off-shore results in both a gross inflow of investment into the United States and a gross outflow. It is essentially a bookkeeping change that does not affect net flows.
- o The figures below show annual increases in IBF claims and liabilities in U.S. banks.

|             |          |           |           |           |
|-------------|----------|-----------|-----------|-----------|
|             | 1980     | 1981      | 1982      | 1983      |
| Claims      | <u>0</u> | <u>26</u> | <u>36</u> | <u>17</u> |
| Liabilities | 0        | 23        | 35        | 17        |

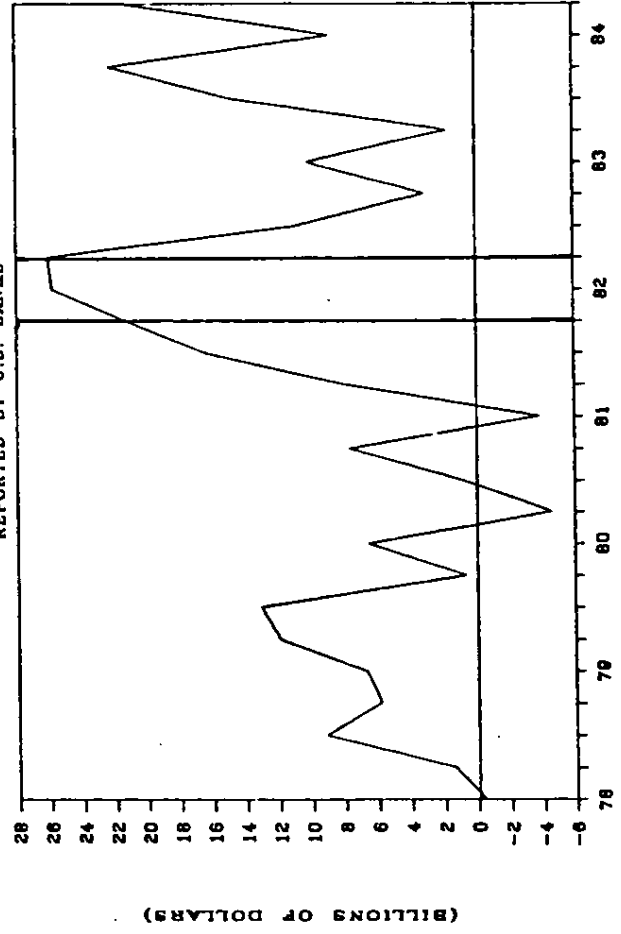
- o The gross investment figures (both inflow and outflow) are distorted upward by about the amount of these increases in IBF claims (outflows) and liabilities (inflows).
- o While quarterly figures for IBF accounts are not available, evidence from the institutions involved indicates that most of this activity occurred in the fourth quarter of 1981 and the first two quarters of 1982.
- o Quarterly figures on gross inflows and gross outflows through the banking system (shown below) are consistent with this evidence. Note the peak inflows and outflows in Q4/81 through Q2/82.

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# GROSS OUTFLOWS OF U.S. INVESTMENT REPORTED BY U.S. BANKS



# GROSS INFLOWS OF FOREIGN INVESTMENT REPORTED BY U.S. BANKS





October 26, 1984

## MEMORANDUM FOR CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Beryl W. Sprinkel *Beryl W. Sprinkel*

SUBJECT: The Economy, Interest Rates and Monetary Policy

When we last met with you in August the economy was still growing at a rate which some considered unsustainable, credit demands remained strong and short-term interest rates were rising. Long-term interest rates had declined somewhat from their peak levels in June, but despite continued low rates of inflation the level of long-term rates was still above that which seemed consistent with perceived trends in future inflation.

The situation now is quite different. There have been two cuts in the prime, from 13 percent during July through September, to 12-1/2 percent presently and with good prospects of additional reductions. Short-term interest rates as represented by 90-day T-bills peaked at 10.65 percent in late August and have declined about 150 basis points since then; some other short-term rates have dropped more. The decline in long-term rates has continued, and long rates have now declined 120-180 basis points from their June peaks.

The improvement in interest rates can be traced to four principal developments. First, the greater-than-anticipated slowdown in real economic growth has reduced private credit demands. Second, the deceleration in the rate of money growth since early in the year, as well as the slowing in the rate of economic expansion, have allayed fears about renewed inflationary pressures. Third, there has been a substantial decline in the Federal funds rate, which in the context of slow money growth since June, has encouraged the view that the Fed has adopted an easier policy stance in order to stimulate additional money growth. Finally, there has been some abatement in market perceptions of the default risk associated with banking sector instability.

During August and until early September, the consensus outlook for real GNP growth among forecasters (Blue Chip) for 1984:3Q was 4.7 percent, compared with 7 percent growth in the second quarter. Thus the September flash estimate of 3.6 percent real GNP growth for the third quarter, and the October preliminary estimate of 2.7 percent real growth, implied that the economy was slowing down much more rapidly than most analysts had previously anticipated. As a result, the fears of impending overheating and with it, a significant rise in future inflation and the possible emergence of substantial crowding out in financial markets, were all tempered to an important extent by the release of this and other recent economic data. The downward adjustment in interest rates partly reflects these changed expectations.

Additional downward pressure on interest rates can be traced to developments in Federal Reserve policy. The Federal funds rate, which had been trading around 11-1/2 percent in August and most of September, has recently moved below 10 percent. This adjustment in the Federal funds rate is looked upon as a signal of Fed policy intentions. The level of M1 has been generally flat since early June; as a result, the weekly level of M1 has moved from the top of the 4-8 percent target range in mid-June to just above the lower target bound in mid-October. The behavior of M1 relative to its target range has led to the market perception that the Fed has the room (within the target range) and the need to provide more reserve growth in the near-term future, in order to restore moderate money growth in the months ahead; such policy actions would, of course, imply a lower Federal funds rate. Moreover, this view has been reinforced by the slowdown in real growth, low inflation and the strength of the dollar in the foreign exchange markets.

In addition, there is an apparent easing of market concerns about the stability of the banking system. An index of this concern is the spread between the rate on 90-day certificates of deposits issued by banks and the rate on 90-day T-bills. When investors question the balance sheet integrity of major banks they move into Treasury securities and away from CD's, raising the CD - T-bill spread. In late June and early July the weekly average of this spread rose as high as 186 basis points. By early October it had fallen to around 80 basis points. Thus, part of the rise in rates during the summer could be traced to an increase in perceived credit risk, while part of the decline presently underway appears to be due to some reduction in those concerns.

#### Concerns for the Future

While we obviously welcome the favorable developments in interest rates that have occurred since this summer, there are reasons to remain on the alert.

Money supply growth has been decelerating throughout 1984; from the second quarter to the third quarter, M1 grew at an annual compound rate of 4.7 percent, compared to a 7.4 percent rate during the first quarter of the year. Both long- and short-term interest rates have benefited from the deceleration in money growth by reducing fears of future inflation and by reinforcing the view that the expected course of Federal Reserve policies will be shaded toward allowing a lower Federal funds rate. There is some growing concern, however, that a continued deceleration in money growth, that resulted in a protracted period of zero or near-zero money growth, would raise the risk of an unacceptable cyclical reduction in real economic activity.

It is very possible that some of the observed decline in the Federal funds rate is due to technical and transitory factors; nevertheless, it is clear that Fed policy actions have been designed to foster a lower Federal funds rate in order to restore moderate

growth in reserves and the money supply. However, it is not possible to say whether the Federal funds rate has declined enough to generate the reserve and money growth that is needed.

We have discussed with this group on many occasions in the past the risks inherent in the Fed's procedure of manipulating the Federal funds rate in order to control money growth. Since the relationship between interest rates and money growth is notoriously unreliable, long periods of money growth that is either too fast or too slow can result if the Fed misjudges the movement in the Federal funds rate that is consistent with a desired change in money growth. Such errors are particularly likely to occur when the direction and/or intensity of market pressures on interest rates are changing.

It is of course extremely difficult to forecast the timing and intensity of changes in interest rates emanating from fundamental market forces. In addition, since market pressures may either offset or reinforce the impact of Federal Reserve actions, it is difficult to disentangle market pressures from policy-related pressures on interest rates. It is also difficult to sort out how much of a change in interest rates is fundamental, and how much is the result of speculation about future Fed policy. Thus it is a complex task to judge, in changing market conditions, what change in the Fed funds rate target is needed to generate a desired change in money growth. If the Fed adheres to a Federal funds rate target that is not consistent with desired money growth, money growth typically goes awry.

We have frequently argued publicly and privately that the best way for the Fed to assure desired money growth is to allow market forces to determine the Federal funds rate; the Fed should focus its policy actions directly on providing the reserve growth needed to generate desired money growth. In the current situation, the behavior of the Federal fund rate implies that compared to previous experience, the Fed is allowing market forces a greater role in determining the Fed funds rate. If this is the case, the probability of erring in the direction of providing too little money growth, and thereby inducing a monetary restriction of the economy, would be reduced.

It is important to recognize that concern about sluggish money growth in the short run does not imply that the inflation war has been won or that we encourage a reacceleration of money growth to an inflationary pace. It is the long-term trend of money growth that drives the inflation rate. We should continue to encourage the Federal Reserve to seek a stable, noninflationary path for reserves and the money supply. Such a policy would greatly enhance the prospects of more stable short-term real growth, without endangering the substantial gains that have been made toward reducing the trend rate of inflation. The additional benefits of pursuing such a monetary policy would be an improvement in banking sector stability, and some decrease in the volatility of dollar exchange rates.

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- o This means that both gross inflows and gross outflows for 1982 are artificially inflated and that the apparent drop in gross inflows from 1982 to 1983 should not suggest that we are not "draining capital" from abroad.